G Padmanabhan: Managing currency risk in the new normal

Special address by Mr G Padmanabhan, Executive Director of the Reserve Bank of India, at the Iforex Leaders Summit, Mumbai, 28 July 2012.

* * *

Assistance provided by S/shri G Mahalingam, Sudarsana Sahoo and S Rath gratefully acknowledged.

Ladies and Gentlemen,

I am happy to be here today and share with you my perspectives on this interesting theme of the Seminar. It does take a lot of courage to coin anything as “normal” these days.

What is “New Normal”?

1. Mr. Mohamed El-Erian and Mr. Bill Gross of *Pacific Investment Management Company* (PIMCO)coined the phrase “*New Normal*” during early 2009 that basically signifies a downward shift in potential growth of the advanced economies post-crisis and the consequent change in the global economic order with the emerging economies moving to the centre stage. The phrase captured the imagination of the world and started to be used in varied contexts to broadly underscore regime shifts and hard transformation.

What is “New Normal” in the context of currency risk?

2. The current level of INR-USD exchange rate is being talked as “New Normal”. Some people also cite the level of volatility that INR-USD exchange rate has been witnessing during the recent period as “New Normal”. The Rupee has witnessed sharp depreciation and increased volatility during the recent period driven by both global and domestic factors. The episode began after the historic downgrade of USA by S&P in August 2011 that triggered heightened risk aversion and sell-off of assets of emerging economies including India by the foreign institutional investors (FIIs). The risk aversion environment has further heightened on escalating euro-zone concerns and falling global growth. The weakness in macro-economic fundamentals, bottleneck issues relating to infrastructure and concerns over implementation of GAAR have dented India’s appeal as an investment destination leading to further fall in capital inflows. Apart from the growth perception of the Indian economy, risk appetite of the global investors and growth prospects of competing economies have driven the magnitude and direction of capital flows to India. Thus, the flows are largely autonomous and remain beyond the reach of conventional policy instruments. On the other hand, the trade balance deteriorated despite depreciation of the rupee mainly due to relatively price inelastic nature of some of India’s imports, as well as a slowdown in exports reflecting falling global demands. The current account deficit (CAD) significantly widened during FY 2012–13 to touch the high of 4% of GDP. The widening of CAD in the backdrop of large decline in capital flows exerted severe downward pressure on Rupee with consequent volatility.

3. In this context, it has to be appreciated that the volatility regime has undergone a significant shift and volatility in most of the asset classes as well as segments of financial markets has risen significantly since the onset of the global financial crisis in August 2007. The forex, equity, bond, and commodity markets have been extremely volatile during the period as global economic outlook remains “unusually uncertain” making it difficult for economic agents to make optimal and informed decisions. In the foreign exchange market, the direction of Rupee’s movement has remained largely in sync with that of several emerging market currencies and more so with some of the major currencies but the magnitude of depreciation has been far more pronounced.

4. The so called "New Normal" in the dynamics of INR-USD exchange rate also reflects greater influence of the global financial markets on the domestic foreign exchange market mainly due to India's growing trade and financial integration with the rest of the world. India's two way trade (merchandize exports plus imports), as a proportion of GDP, was 40.7 per cent in 2008–09, the crisis year, up from 19.6 per cent in 1998–99. The ratio of total external transactions (gross current account flows plus gross capital account flows) to GDP – an indicator of both trade and financial integration – was 112 per cent in 2008–09 up from 44 per cent in 1998–99.

5. There is another fundamental aspect that we cannot lose sight of. Indian Rupee has to adjust its value vis-a-vis other major foreign currencies to reflect inflation and growth differentials. In a market ruled by multiplicity of pressures, it is too optimistic to expect this adjustment to always happen in a smooth and secular manner spread across the time horizon. The experience of the recent past should carry an important and valuable lesson for all of us. Any stability over an extended period of time could be a harbinger of volatility. If so, too much stability, instead of breeding complacency among corporates, should actually increase the state of alertness.

Managing currency risk under the "New Normal"

6. Excessive volatility in the exchange rate makes it difficult for economic agents to make optimal inter-temporal decisions. The economic agents, therefore, need to properly understand and measure the nature of currency risk embedded in their business and use appropriate derivative instruments to hedge their currency risks. The derivative instruments help corporates to convert uncertain future cash flows to certain ones so that they can optimise business decisions based on predictable revenues and costs. Reserve Bank, over the years has expanded the menu of derivative instruments, both OTC as well as exchange traded ones that has provided greater flexibility to the market participants in managing their currency risk.

7. The derivative products chosen should be consistent with the users' business, financial operations, skill and sophistication, internal policies as well as risk appetite. Reserve Bank has cast responsibility on banks for carrying out suitability and appropriateness tests while transacting a derivative instrument with the corporates and also ensuring that the corporate has appropriate risk management framework. Though the RBI has imposed the responsibility for due diligence and appropriateness of a derivative contract on the banks, the end-user corporates do have a great responsibility in this regard. Identification, measurement and management of risks should be an integral part of the corporate governance structure. Leaving risks unidentified and hence unmanaged is as much a sub-optimal phenomenon as using ill-understood products for managing risks. Inadequate understanding of the risks and future obligations under the derivative contracts has led to many legal disputes in the recent past.

8. The hedging activities of the corporates should be an integral part of their overall risk management policy and mechanism. There should be a board approved written policy in place which define the overall framework within which hedging activities should be conducted and the risks controlled. Such policy must clearly lay down, inter-alia, guidelines on risk identification, management and control, prudent accounting and disclosure norms and must be capable of ascertaining the mark to market positions on an on-going basis. It is desirable that the board of directors and senior management should understand the basic attributes of different forex derivative products and the suitability of these products for hedging their underlying currency risks. It is also necessary to ensure that clear lines of responsibility and accountability are established for the hedging activity through use of derivatives.

9. Now let me spend a few minutes to reflect upon the current forex markets and the recent measures undertaken by Reserve Bank.

Availability of hedging instruments

10. The availability of hedging instruments was never a major concern for the Indian forex markets. Instruments such as forwards, swaps and options have been available to market participants since FERA days with cross-currency options available from 1993. In the OTC segment the last entry was that of FCY-INR rupee options way back in 2003. All the instruments have become well entrenched in the market with different segments of corporates showing preference for different instruments.

11. The recent entrant into the market, currency futures in 2008, has not only generated a good bit of interest from participants but also queered the pitch a bit on account of the different regulatory environment it has been subjected to. First launched on NSE it was subsequently available on two other exchanges (MCX & USE). European style option on USD-INR pairs was launched on NSE and USE in October 2010. While presence of an underlying exposure is an essential requirement in the OTC segment, no such requirement is in place for the exchange traded derivatives segment. This has created two different markets for the same underlying currency pair namely USD-INR. On account of having a sub-set of participants common to both the markets, the volatility of one market gets imposed on the other. To deal with this, even if partially, position limits of banks were revised on exposures to exchange traded products.

Liquidity in the market

12. As far as liquidity in the forex markets is concerned, the turnover in the markets has increased many fold during the last ten years and bid-offer spreads have narrowed considerably in the same period. This not only reflects the substantial increase in global trade and financial interaction with the outside world but also the increasing awareness of the corporates to foreign exchange risk and use of derivatives in managing such risks. The forward markets in India also are very liquid up to one year. The only concern in the market being the liquidity of the long term forward market beyond say one year or two year. However, this concern can be negated practically by rolling over a short-term (say one year) contract till the maturity of the exposure which basically replaces the volatility risk of the spot exchange rate with the volatility risk of forward premia which is confined to a far narrower range.

13. The liquidity took a slight beating from December last year when we imposed certain restrictions on the markets to curb the volatility that we witnessed. More on it later, but it was heartening to see the turnover pick up again in recent months despite the fact that the restrictions continue to be in place.

Flexibility in cancellation/rebooking/roll-over for genuine transactions

14. Much has been spoken / debated / argued / discussed about the flexibility to cancel and rebook transactions and also on the facility of rolling over transactions in recent times. What is required is to put in perspective the raison d’être for these flexibilities. The point that I want to highlight here is that the current foreign exchange regulatory regime permits corporate to use forex derivatives for hedging their underlying exposure only. Cancellation and subsequent rebooking were allowed for all transactions undertaken to hedge current account exposures and capital account exposures up to one year. This flexibility was allowed for the corporate to dynamically manage the foreign exchange risk the corporate was exposed to depending on the medium to long term view of the corporate on the currency movements and not to speculate on the intra-day volatility. However, there have been instances in the recent past wherein the flexibilities in hedging provided by the Reserve Bank have been misused by the corporates with speculative intent for generating profits that had exacerbated the volatility of INR-USD exchange rate in the recent period. Finally, Reserve Bank was constrained to resort to administrative measures in December 2011 to curb such speculative practices.

Recent changes made to the Guidelines

What are the changes?

15. As stated earlier, global factors have been increasingly having an impact on the volatility of the forex markets with significant pass through of global volatility. Moreover what is accorded as on add on facility during periods of stability needs to be reviewed during bouts of extreme volatility. Accordingly, to ensure that such disruptions are not exacerbated by action of domestic participants Reserve Bank had to act by taking several measures to calm the market.

Why were these necessary?

16. As this gathering represents more of corporate interests rather than banks, I would restrict myself to the measures affecting corporates.

- Restricting cancellation and rebooking – It was observed from the various transactions undertaken by corporates with banks that the turnover of transactions increased during volatile periods and most of the increase was on account corporates undertaking a hedge and reversing the same intra-day. While undertaking a hedge in a volatile market stands to reason, reversing it on the same day does not in any way reflect the medium to long term view of the corporate. It will be well appreciated by this discerning audience that any position undertaken to take advantage of the one way movement intensifies the move adding to the demand / supply pressures in the market. While it is well appreciated when the move reflects the hedging intention of the corporate, it does not augur well for the market volatility if the same is undertaken to speculate on the market movements.
- It is a well known fact that given the Rupee's strength in recent history (though not very recent), Indian importers generally stay unhedged or have a very small hedge ratio. Even corporates who have both import and export exposures prefer to have their import exposures unhedged while almost fully utilising their export exposures. The same approach is followed in case of probable exposures also. In the current depreciating trend of Rupee, these excess unutilised limits are a cause of concern when used for speculation.
- The past performance facility was made available to corporates in addition to the facility based on actual exposures so as to allow them to plan ahead for managing their foreign currency exposures. Both facilities together amounted to almost double the exposures of the corporates and without any delivery mandate on either could be / were used for speculative purpose.

Does it really constrain the corporates in managing forex risk or were the leeway given earlier enhancing the volatility and being misutilised?

17. Let me emphasise here that the facility of rolling over the transactions continue to be in place to provide the corporate flexibility to alter the tenor of the hedge depending on the liquidity of the tenor, view on the forward premia, availability of pricing and also to match the tenor of the transaction to that of the underlying exposure in case delayed payments, uncertain maturity date (for ex. in case of past performance) etc.

18. Hence, although the restrictions imposed take away certain leeway provided in managing the forex risk, it in no way restricts the ability of the corporate to do so. In a manner of speaking, it only takes away the additional volatility that the P&L of the corporate was subject to on account of forex trading.

Reserve Bank's philosophy on management of forex risk

19. Reserve Bank has always advocated for better management of forex risks by the corporates. From making available different kinds of instruments to providing enabling conditions / regulations to effectively use such instruments in managing the foreign exchange risk, Reserve Bank has always striven to provide corporates with various choices.

20. Further, Reserve Bank has been following a consultative approach while formulating new guidelines or amending old ones. The comments / suggestions received from various stakeholders are analysed and incorporated in to the guidelines if found suitable.

21. Reserve Bank believes that corporates should be concentrating more on their core business to generate returns rather than looking to generate alpha from diversifying into trading in forex markets. As my fellow Senior colleague, Mr V K Sharma, Executive Director aptly observed, and I quote, "risk management is not about eliminating, or which is the same thing as completely hedging risk, but about first determining, like one's pain threshold, risk tolerance threshold and then aligning an entity's existing risk, be it currency, interest rate or commodity price risk, with its risk tolerance threshold. Having said that it would also be in order to have a sense of how risk itself is defined and measured. Risk is uncertainty of future outcomes such as cash flows. In financial theory and practice, it is typically measured by annualised standard deviation of a time-series of percentage changes in asset prices. While courting financial risks in pursuit of financial returns is the staple and dharma of banking and finance industry, it is not so for industrial and manufacturing businesses! The staple and dharma of business and industry is courting their normal core business risks in pursuit of delivering a market-competitive return on equity to shareholders". There cannot be a better advice for the Corporates trying to come to grips with the "new normal" in the changed financial market realities.

22. It is therefore not only in the interest of market stability but also corporate balance sheet that the derivative products are used more responsibly for risk containment, more so on account of the increased volatility in the markets, so that they serve the purpose they were designed for.

23. Related to hedging from the accounting aspect is the issue of marking to market all the outstanding derivative contracts i.e. recording the value of outstanding financial contracts at fair value. In recent times, given the volatility of Rupee much press coverage has been directed towards the Marked To Market (MTM) losses of corporates. The MTM is dynamic in nature and changes in line with market movements and represents the replacement cost of the derivative contracts. These accounting losses should therefore be looked at in totality along with the economic rationale of the hedges undertaken wherein the corporate had decided to lock in to a definite price and to forego the inherent forex risk.

Conclusion

24. Let me now conclude. I have attempted to explain what is new normal in the currency market, how risk management needs to be reviewed and adjusted in the new scenario and responsibility of the Boards in putting in place appropriate policies to manage risks. I have also flagged the RBI moves to bring orderliness in the market and shared with you the thinking process that went behind these measures. In concluding, I want to leave the thought that we expect greater responsibility on the part of corporates in managing their risks which calls for greater understanding of their actions from a macro perspective. In other words, in these extraordinary times it is essential for the central bank to think like the corporates and for the corporates to attempt to think like the central bank or at least understand their actions.

25. Thank you for your attention.